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TRIM – Is the ECB prematurely implementing Basel IV reforms?

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The Basel Committee has not yet found consensus in favour of the so-called Basel IV proposals[1]. One of such proposals' key pieces, a review of the conditions in which banks will be allowed to use internal models to determine own funds requirements in the future, has shifted into public focus recently. Despite the pending discussions within the Basel Committee, the European Central Bank (ECB), as competent regulatory authority under the Single Supervisory Mechanism (SSM), has placed the Targeted Review of Internal Models also referred to as "**TRIM**" at the top of its agenda for 2017.

This prompts the question as to whether or not the ECB anticipates the Basel IV proposals[2] being implemented into enforceable European law. The results of TRIM could have substantial impacts on SSM banks' balance sheets as the TRIM process will also account for potential changes in internal model requirements that are expected to be introduced during the project's lifetime[3]. Reactions by individual banks suggest that the average risk weight on certain asset classes (such as mortgage portfolios) may be raised from 26% to 34% due to TRIM. Other analysts suggest that the TRIM exercise could hit CET1 levels by as much as 60 basis points.

Same Objective - Different Approach

The Basel proposals and the ECB's TRIM share the same objective: bringing consistency to banks which use internal models to calculate risk weights for the purposes of determining own funds requirements. Admittedly, there are differences in approach: on the one side, TRIM attaches itself to the internal models themselves; on the other side, the respective Basel proposals will limit a bank's ability to benefit from using internal models by introducing input floors (i.e. constraining risk parameters for specific portfolios) and setting minimum output floors on the basis of standardised models. Also, Basel IV suggests that internal models may no longer be used for certain exposures such as large corporates and specialised lending exposures. In effect, the transposition of Basel IV would significantly increase the amount of risk weighted assets (RWAs) resulting in higher own funds requirements.

1 Comprising amongst others of BCBS 306, 347 and 362 and which technically finalise and further calibrate the existing Basel III reform package regarding the applicability of internal models, but due to its potential large impact often are referred to by the banking industry as the part of the Basel IV reforms.

2 BCBS 362 (March 2016) Consultative Document: Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches.

3 https://www.bankingsupervision.europa.eu/press/publications/newsletter/2017/html/nl170215_1.en.html

By way of release of a new explanatory statement[4] and invitation to a conference on TRIM at the end of February 2017, the ECB has reinforced momentum on TRIM. Initially launched in late 2015, TRIM has now been set to be one of the top regulatory priorities[5] pursued by the ECB this year. As a result, at least 100 on-site missions at SSM banks will take place in 2017 each requiring at least six people over a period of at least ten weeks[6]. This will not only require approximately 100 supervisors of the ECB and of national competent authorities to be involved, but also significant numbers of external consultants. In addition, the current version of a 150-page guide[7] on TRIM published by the ECB at the same time provides further details.

TRIM as another road block for Basel IV?

The ECB's timing is noteworthy: just prior to the ECB prompting this intense new push for the TRIM exercise, the Basel IV process has significantly slowed down. A meeting of the Basel's GHOS[8] on the topic that was scheduled for 8 January 2017 was cancelled without any replacement meeting date being mentioned. Cancellation of this important meeting comes against the background of diverging views within the GHOS on whether and how to proceed with the Basel IV proposals. European regulators expressed concerns that any further restrictions may impede banks' lending capabilities as many major European banks still struggle with legacy issues. On the other hand, the US is pushing for tighter rules whereby US banks are said to be less affected. Given that the use of internal models is already heavily restricted in the US, only a small number of the biggest US banks are allowed to use internal models at all. Also, US banks already appear to have recovered from the financial crisis much better than European banks. In addition the new US administration announced that it plans to roll back banking regulation for US banks, which may increase the pressure for European banks. As decisions by the Basel Committee need to be taken by consensus, it seems questionable that an agreement on a final Basel IV reform package can be reached in the near future. Against this background, the ECB's new focus on TRIM can be interpreted as another road block for finalising Basel IV.

TRIM: Why now and what will it bring about?

So why is the ECB getting pro-active right now even though European regulators raised concerns against the proposed more stringent Basel IV requirements? As competent regulator for various Eurozone member states' banks, the ECB was able to identify differences of internal models. This seems unsurprising due to the nature of "internal" models, but it effectively results in banks being differently protected against unexpected loss. Also, a recent working paper of the ECB[9] suggests that some banks making use of the internal risk estimates employed for regulatory purposes systematically underpredict actual default rates by 0.5 to 1 percentage points and thus play right into the hands of critics of such internal models.

Therefore, whilst the ECB continues to believe that internal models can play a useful role in determining own funds requirements, this is subject to the caveat that risks must be modelled adequately and models must give consistent results. It is expressly not the intention of the ECB to generally increase RWAs on the back of the TRIM exercise. However, the ECB's aim is to "reduce unwarranted variability in RWAs across banks", reduce complexity of internal modelling and create a level playing field by harmonising supervisory practices.

As a result of TRIM, internal models will effectively become more streamlined and their RWA effects more "standardised". Therefore, it seems quite likely that remedial actions required by the ECB as a result of TRIM ultimately will lead to higher RWA levels on particular exposure classes subject to internal models.

It remains to be seen how the ECB factually handles the TRIM exercise and what its administrative practice will look like with regard to requiring banks to address deficiencies identified by the ECB. It must be noted that the Basel IV proposals are neither decided in the Committee at the Basel level yet nor have they been implemented into European enforceable laws. Hence, it will be a thin line between, on the one side, appropriately making use of general empowerments of a regulatory authority under the CRR and the SSM and, on the other side, creating additional regulatory requirements that do not become enshrined in law.

4 https://www.bankingsupervision.europa.eu/about/ssmexplained/html/trim.en.html

5 https://www.bankingsupervision.europa.eu/ecb/pub/pdf/publication_supervisory_priorities_2017.en.pdf

6 https://www.bankingsupervision.europa.eu/press/publications/newsletter/2017/html/nl170215_1.en.html

7 https://www.bankingsupervision.europa.eu/ecb/pub/pdf/trim_guide.en.pdf

8 The GHOS is the oversight body of the Basel Committee, comprising of central bank Governors an (non-central bank) heads of supervision from the Committee's members, which resemble 45 members from 28 jurisdictions.

9 ECB Working Paper No 1928 / July 2016, Behn/Haselmann/Vig, The limits of model-based regulation.

Balance Sheet Optimisation and TRIM

Banks will consider balance sheet optimisation tools that provide for protection against potential negative side-effects of TRIM. Typical options include risk transfer transactions on affected asset classes in case the bank is comfortable with the economic risk of the related exposures. Such synthetic securitisations enable the bank to buy credit protection against unexpected (and, if applicable, expected) losses as part of the bank's RWA, equity and risk control management. At the TRIM level, this may enable the bank to argue that there is no undue exposure to uncovered risk due to the risk-transfer fallback. At the same time, such risk transfer transactions may protect the bank against the odds of whether or not significant RWA increases will be implemented if Basel IV eventually is agreed upon and implemented. It goes without saying that the benefits of such balance sheet optimisations need to outweigh the costs related thereto. This hurdle is not always easy to overcome in today's low yield environment.

Even though one may consider the TRIM initiative as the less invasive measure compared to full acceptance of the current Basel IV proposals and driven by good intentions, it is still another concern for the European banking sector. The future will show whether TRIM or Basel IV will end up tightening the regulatory grip on European banks, but either way market participants have to put active balance sheet management on their high priority agenda. As of now, TRIM is already in place and probably will be one of the major concerns every market participant has to face going forward. The question one might ask is: how much higher can European banks jump in this macroeconomic environment, if the regulator keeps on telling them to do so?

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